Exchange Eligibility

Do your properties meet IRS requirements for 1031 transactions?

By Ronald L. Raitz, CCIM- Online Article

Joseph and Sara bought a three-bedroom rental home that needed repair. After several months, they had completed the repairs and put the refurbished property on the market for substantially more than their original investment. Subsequently, a buyer put a contract on the property for the full price.

They consider exchanging this house for another investment property to defer capital gains taxes; however, their tax professional informs them that the Internal Revenue Service probably would not approve this exchange. Why not?

Inexperienced real estate investors may be surprised to learn that not all properties qualify for Internal Revenue Code Section 1031 tax-deferred exchanges. The IRC clearly stipulates that both relinquished and replacement properties must be held as investments for a specific period and cannot be personal-use properties or properties held primarily for sale, or inventory. While these requirements sound simple, they have the potential to derail exchange transactions. To help investors successfully exchange property, commercial real estate professionals must know what the IRS considers an appropriate holding period and how it defines personal use and inventory.

Holding Period Requirement

Many first-time exchangers often want to know how long they must own or hold a property before exchanging it. Unfortunately, the IRS hasn't stipulated a definitive time frame. The only reference to this issue was in a 1984 private letter ruling in which the IRS deemed two years as an appropriate length of time.

Some tax professionals look to the definition of short-term and long-term capital gain as a guideline. Under current tax law, an investment held for one year or longer qualifies for capital gain treatment. On two separate occasions, the IRS unsuccessfully asked Congress to add a one-year minimum holding period to IRC Section 1031.

The courts have leaned heavily toward establishing the taxpayer's original intent to hold the property for investment as a means to define the necessary time period. The taxpayer's intended use of relinquished and replacement properties is determined when the exchange takes place. Whether either property is deemed to have been used appropriately is a question of fact; the burden of proof lies with the taxpayer.

The taxpayer's action also must be consistent with holding a long-term investment. Actions such as signing a listing agreement or putting a for-sale sign on the property immediately after acquiring it are viewed as inconsistent with the stated intent to hold the property as an investment. As a general rule, if a taxpayer holds a property for less than one year before disposition, he may have to defend his original intent if attempting to use this property in an exchange.

Personal-Use Allowances

The IRS requires taxpayers to hold relinquished and replacement properties for use in a trade or business or for investment. Under this definition, personal residences are not eligible. However, under IRC Section 121 guidelines, taxpayers have very liberal allowances that provide for up to $500,000 of gain to be excluded from capital gains tax.

For tax purposes, most tax professionals feel that personal-use second homes are not considered to be held primarily for investment because they have no rental activity and the taxpayer is the only user. Ifa taxpayer complies with the personal-use allowances for investment homes (use for no more than 14 days out of the year or 10 percent of the time that it is rented whichever is greater) it should qualify as investment property.

Inventory Regulations

Section 1031 clearly excludes any property held primarily for sale from being used in an exchange. The IRS commonly uses the term dealer inventory to describe this type of disqualified property. For tax purposes, a dealer is someone who holds property for the primary purpose of selling it in the ordinary course of his business. Inventory describes the type of goods that a dealer sells.

For example, a developer who buys, rezones, and subdivides land into lots for subsequent sale easily is identified as a dealer. His inventory is the lots. But what about a taxpayer with an unrelated, full-time occupation who buys and sells real estate in his spare time? Would he be deemed a dealer?

It is important to make a distinction between the dealer and dealer inventory, as Section 1031 requirements are property specific, not person specific. Consider a builder who acquires a land parcel and subdivides and subsequently sells 60 percent of the property. Meanwhile, he retains the remaining 40 percent with the intent of holding it long term to sell in the future as an investment. While the 60 percent subdivided portion (inventory) would not qualify for 1031 treatment, the remaining 40 percent probably would be eligible if sold in bulk several years later.

Another example is a pilot named Paul, who owns a 12-unit apartment complex and decides to convert each unit into condominiums for immediate sale to individual owners. Even though Paul is not a real estate developer, the IRS would consider the property dealer inventory and treat it as such in an exchange.

Taxpayers should consider the following questions to determine whether either their relinquished or replacement property is held primarily for sale or for investment.

1. What was the original purpose for which the property was acquired?

2. What did the taxpayer do with the property subsequent to the acquisition?

3. Did the taxpayer make any developer improvements to the property?

4. Were any marketing activities, such as posting for-sale signs or signing a listing agreement, initiated immediately after the acquisition?

5. Was the accounting method used to report the property consistent with inventory or investment?

As you can see, what constitutes qualified property for a 1031 exchange must be filtered through the holding period, personal-use, and inventory categories. Commercial real estate pros and taxpayers should seek guidance from a qualified tax adviser to determine what qualifies for an exchange transaction.

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